

MARKET CONDUCT EXAMINATION REPORT

FARMERS INSURANCE EXCHANGE

**By Representatives of the
North Dakota Insurance Department**

June 2007

STATE OF NORTH DAKOTA
DEPARTMENT OF INSURANCE

I, the undersigned, Commissioner of Insurance of the State of North Dakota, do hereby certify that I have compared the annexed copy of the Market Conduct Examination Report of the

**Farmers Insurance Exchange
Los Angeles, California**

with the original on file in this Department and that the same is a correct transcript therefrom and of the whole of said original.

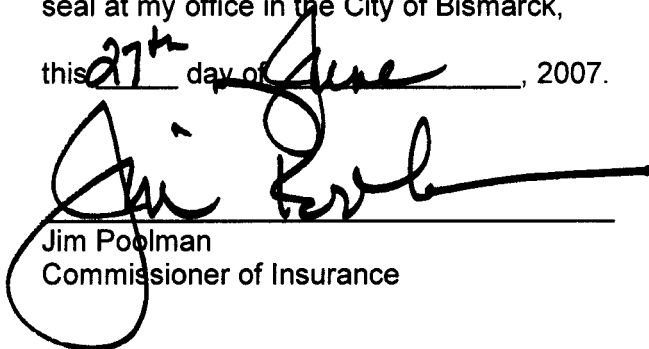


IN WITNESS WHEREOF, I have hereunto

set my hand and affixed my official

seal at my office in the City of Bismarck,

this 27th day of June, 2007.



Jim Poolman
Commissioner of Insurance

I. Introduction

On August 8, 2004, the North Dakota Insurance Commissioner, Jim Poolman, ordered a limited scope examination of Farmers Insurance Exchange ("Farmers") pursuant to the authority set forth in N.D. Cent. Code § 26.1-03-19.2. The Examiners reviewed Farmers' claims activities from January 1, 1990, through August 1, 2004. The Examination followed the NAIC Market Conduct Handbook Procedures. (The Examiners conducted the exam of the Company under the rules and regulations prescribed by the NAIC to evaluate Farmers' compliance with statutes and regulations relating to market conduct practices and Farmers' treatment of policyholders and claimants.)

This report of examination is confined to comments on activities that allegedly involve departures from laws, regulations or bulletins and questionable business practices or patterns that are determined to be contrary or detrimental to the best interest of the insurance-buying public and require special explanation or description. Standards as prescribed by the NAIC Market Conduct Examiners Handbook are only described in detail where the examiners concluded Farmers may not be meeting a specified standard. The failure to identify or criticize certain practices does not constitute acceptance by the Examiners.

II. Areas of Review

The Examiners review was conducted in the area of Farmers' claims handling practices. This review included an investigation into Farmers' incentive programs and employee performance goals and evaluations as applied to those claims handling practices.

In the course of the examination, the Examiners reviewed the following documents:

Personnel files of 30 Farmers employees in the Bismarck, North Dakota, branch office, including files of claims handlers, supervisors, branch office claims supervisors, branch office claims managers, regional claims managers and regional staff, and "performance, planning and review" forms that were used in evaluations of Bismarck personnel.

Over 5,000 pages of documents produced during discovery in a civil case in South Dakota, including performance evaluations, manuals, company letters, company emails, company planning memorandums, company strategic conference planning videos, company financial information and other documentation.

Legal documents from a South Dakota case, including motions, deposition transcripts, deposition videos, exhibits, affidavits, hearing transcripts, court orders and other documents.

All of these documents reviewed by the Examiners in the course of their examination were generated pursuant to discovery in two cases, as well as briefs written by Plaintiffs' attorney. In addition, the Examiners reviewed a paper prepared by the Plaintiff's attorney entitled "The Farmer Insurance Group - History, Corporate Structure, Compensation Programs, and Claim Department Goals." Both the briefs and the paper discuss activities at the Bismarck, North Dakota, claims office and evaluations of personnel in that office.

III. Company History

A series of catastrophic events in 1994, including the Northridge earthquake in California, resulted in Farmers paying out over \$2 billion in insured losses. As a result, Farmers experienced a significant reduction of its policyholders' surplus. In response to this situation, Farmers instituted a slogan, "Bring Back a Billion," as well as certain programs, including a program called "Quest for Gold," along with other cost-cutting, "non-rate" programs, all in an attempt to focus efforts on rebuilding that surplus. The stated goals of these programs included cutting costs and reducing the occurrence of claims handlers paying more than was required on particular claims, as well as reducing the possibility of paying on fraudulent claims. Farmers voluntarily terminated these programs in 2002. These programs were the focus of the litigation filed against Farmers, and, as a result, the focus of the Examiners' investigation and Report.

IV. Scope of Examination

1. *Incentive Programs and Slogans*

The "Bring Back a Billion" slogan, adopted on a company-wide basis in 1994, was aimed at encouraging all Farmers' employees to work to rebuild the surplus that was lost as a result of the several natural disasters in that year. Some employees signed "pledges" as part of this slogan campaign, promising to work toward rebuilding the surplus.

The "Quest for Gold" program, implemented in 1998, involved awarding bonuses to offices and management groups that met certain goals related to overall performance, and included cost cutting goals for all groups and offices. The Bismarck, North Dakota, branch claims office included specific monetary goals in individual claims employees' "Performance, Planning and Review" forms ("PP&R"), which are evaluation forms that include the performance plan for the particular employee, as well as the review for each objective in that plan. The PP&Rs from the Bismarck office included the employees' performance as judged against numerous goals including "average claim payment goals" from prior years, adjusted for inflation. These individuals' evaluations noted whether they had met the average claim payment goal, exceeded it, or failed to meet that goal for the year.

2. *Non-Rate Action Plans*

In addition to the programs described above, the Examiners reviewed several "Non-Rate Action Plans" with specific goals applicable to claims handlers. These plans include goals to reduce attorney involvement, goals to use comparative fault analysis in

claims handling, and goals regarding reporting claims to the Special Investigative Unit. Again, this information was derived from individual PP&Rs for employees from the Bismarck office, and from other non-North Dakota personnel, as well as internal Farmers documents produced in the South Dakota case. The Examiners also note the Farmers motto with respect to paying claims, which is the following: "Pay What We Owe, Nothing More, Nothing Less."

3. *Quality Assurance Audits*

Finally, the Examiners reviewed the "Quality Assurance Audits" undertaken after a claim is settled, to determine compliance with procedures and an evaluation as to whether a claim was overpaid. According to deposition testimony and the PP&Rs, the percentage of claims considered to be "overpaid" was included in the office evaluation, and some PP&Rs discussed how high the percentage of overpayments was for that particular employee in comparison to the stated goal for the Bismarck office.

V. Examiner Findings

Based on employee PP&Rs, documents produced in the litigation, selected testimony and the briefs written by Plaintiff's attorney, the Examiner makes the following conclusions and findings with respect to the operation of the programs described above:

1. As early as 1990 and before, the management of Farmers Insurance Exchange set various goals for claims handlers and other employees in an effort to increase company profits and thereby grow company surplus.
2. The Company evaluated employee performance based on whether employees met the goals assigned by management. The performance evaluation process was designed to link to the Company's pay system. Employees were informed that their individual performance ratings would play a key role in determining their pay level each year.
3. Many of the performance goals for individual claims employees were appropriate. However, goals that were arbitrary and unfair to policyholders and claimants were also identified.
4. The Bismarck Branch Claims Office's PP&Rs included unfair and arbitrary goals (1) to maintain an average cost claim, allowing for inflationary amounts, at the previous year's level or below, (2) to settle bodily injury claims within a predetermined range and maintain average medical payment amounts, (3) to utilize comparative negligence in at least a certain set percentage of claims, (4) to increase the number of fraud referrals, (5) to decrease the number of claimants that hire an attorney, (6) to close a set percentage of claims without payment, (7) to estimate the condition of damaged vehicles at or below the national average to minimize indemnity payments, and (8) to require that Quality Assurance overpayments be no more than a small percentage of the total claim payments, as determined by a subjective after the fact audit. These goals

were set without regard to the nature or merits of the individual claims that might be handled by the individual claims settlement personnel.

5. The Company evaluated the performance of claims employees based, in part, on these unfair and arbitrary goals.
6. These unfair and arbitrary goals do not take into account or make allowance for the unique circumstances or facts of each individual claim.
7. Slogans such as Bring Back a Billion and incentive programs such as Quest for Gold may have created certain bias or interest on the part of claims handlers to pay less on claims.
8. The unique circumstances and facts which comprise each individual claim are beyond the control of claims handlers.
9. Because meeting these unfair and arbitrary goals was a part of the performance evaluation process and, therefore, linked to an employee's pay, a potential conflict of interest was created between meeting these goals and effectuating a prompt, fair, and equitable settlement of each individual claim on its merits. This potential conflict may have created a certain bias or interest on the part of claims handlers, in some instances, to pay less on claims or to handle claims in an inappropriate manner in order to meet these goals.
10. The adoption and use of the performance goals identified in Examiner's Finding No. 4 to assess the performance of claims handling employees constitutes an unfair practice in the business of insurance under N.D. Cent. Code § 26.1-04-02 and an unfair claim settlement practice under N.D. Cent. Code § 26.1-04-03(9).

VI. Recommendations

- *It is recommended that Farmers eliminate all incentive plans that utilize goals relating to settling claims within certain ranges in the evaluation of, determination of compensation for, or the training of claims settlement personnel, where "goals" means fixed targets and benchmarks which do not focus solely on the nature of the individual claims handled by the individual claims settlement personnel.*
- *It is recommended that Farmers emphasize in its training program materials for newly hired claims settlement personnel the importance of evaluating each claim on its own merit and to neither underpay or overpay claims.*
- *It is recommended that Farmers notify existing claims settlement personnel that the role of incentive programs is to reward exemplary performance and achievement of the Farmers' goals, and that one of the Farmers' goals is to pay the amount due on all claims as quickly and efficiently as possible.*

VII. Farmers' Response

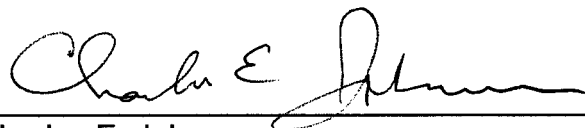
Farmers does not agree that any of the incentive programs, employee PP&Rs or the 1994 "Bring Back a Billion" slogan resulted in any violations of the North Dakota Insurance Code. In addition, Farmers notes that the criticized programs, as well as the PP&Rs reviewed by the Department, were in place or created in the 1990s and do not reflect the Company's practices today. The Company also notes that it had a change of leadership in 2002. The new leadership has brought an increased focus on compliance and the avoidance of any appearance of impropriety. This has resulted in an enhanced awareness among claims handling staff of the need to pay what is owed on a claim in a timely manner and a clear understanding of its incentive programs.

In response to the recommendations made by the Examiners in this Report, Farmers has agreed to implement the following proposals to the extent that Farmers had not already undertaken the proposal on its own initiative:

1. Eliminate incentive plans that utilize goals relating to settling claims within certain ranges in the evaluation of, determination of compensation for, or the training of claims settlement personnel.
2. Emphasize the importance of evaluating each claim on its own merit and to neither underpay or overpay claims, in the materials used in training programs for newly hired claims settlement personnel.
3. Notify existing claims settlement personnel that the role of incentive programs is to reward exemplary performance and achievement of the Respondent's goals, and that one of the Respondent's goals is to pay the amount due on all claims as quickly, fairly, and efficiently as possible.

DATED this 20th day of June, 2007.

Respectfully submitted,



Charles E. Johnson
Examiner in Charge on behalf
of the North Dakota Insurance Department